Labor Bonding

Iulia Igescu

April 17, 2002

Abstract

Bonding policies are often used by modern economies to expand their markets and welfare. Several labor bonding institutions are described with the goal of providing an explanation for their success or failure in various countries.

1 Bonding Institutions

"That the output today is so high, is not a natural or technical phenomenon independent of all social interactions, but rather the result of our social institutions", writes von Mises in his book *Liberalismus.* In the current economic literature institutions are mostly studied either for their efficiency implications by neoclassical economists, or for their impact on distribution and inequality by Marxist economists. Some scholars begin to acknowledge that increases in the level of output in developed countries in the second half of the twentieth century were made possible by the creation of new social institutions in the nineteenth century, during the Great Depression, or after the Second World War. That could put the role of institutions into a new light: as instruments able to change the internal dynamics of an economic system, therefore as promoters of higher levels of output in the long run. Schelling (1960) and Eichengreen (in Crafts and Toniolo, 1996) refer to these institutions as bonding institutions. Their main goal was to increase output by investing in domestic and international market development. While the diversity of national and international institutions makes an exhaustive description impossible, some typical examples will be described in this article.

International organizations such as the World Bank or the IMF were created to help local economies in their efforts to increase output. The European Union had as goal not only the funding of sector development in various western European countries, but also the long run goal of building a strong European market as a sum of well developed national ones. Japan has also strongly invested in other East Asian countries such as Korea or Taiwan and transformed local industries into suppliers of components for the metropolitan economy of Japan (Castley, 1997). The generous access to the United States market stimulated Japan to import from ASEAN to promote economic development. Output in the region grew together with the expansion of the Japanese market.

So far the greatest impact on output has come from national institutions. The New Deal in the US, the welfare state in western Europe, lifetime employment in Japan were all indicators of a profound change in how national institutions, especially government, understood their role in the economy. Eichengreen (op.cit.) distinguishes between national bonding institutions for capital and for labor. Institutions to bond capital were subsidies for steel and aircraft industry in Germany, regulations limiting the payments of dividends by public companies in Sweden, or again subsidies for "strategic industries" in Korea. Labor bonding institutions, the subject of this paper, included health insurance, child benefits and centralized pensions in Belgium, legislation improving working conditions in Norway, policies of re-training, education and job placement services in Sweden. Sen (1999) adds to these examples the human development policy pursued by Japan during the Meiji era (1868-1911) when massive expansion of education and health care were implemented, before the restrains of poverty were broken. He also includes pre-reform China and its efforts to provide basic education and widely shared health care as a pre-condition for the success of the reforms started in 1979. That is opposed to the experience of India whose reforms started with a half-illiterate population in 1991. Beside material benefits offered to its members, labor bonding institutions have also served to improve connections between government and various categories of economic agents. For example in Europe after War World II, unions and employer's associations were encouraged to exchange information on wage and investment decisions, through government. Employees were allowed to be represented in the executive board of a corporation. "Solidarity" between agents of various ages, sex or skills was promoted by a system of centralized pensions, by social pacts which entailed narrowing earning differentials between men and women or intrasectorial income disparities. In this way labor bonding institutions led to higher productivity and higher wages and output in equilibrium (Eichengreen, op.cit.). There are two main differences between bonding and simple public transfers. Labor bonding strives to improve the working conditions of agents, rather than directly increase consumption. It involves a change of attitude towards the future and a commitment to long term economic policies.

Labor bonding institutions have in other words a material component (are funded by public money to improve working conditions) and an "emotional" one (stimulate agents to develop connections to the government as well as to other agents, a safety net that allows them to commit to long term growth policies). They are viewed as an extension of government attributes with the goal of changing the internal dynamics of an economic system. By concentrating on a certain policy (such as one of full employment for example) a government could generate a transition path to a higher level of output. Questions such as under what circumstances such a policy is possible, the costs and benefits for an economic agent, and the causes of failed bonding in different regions of the Globe will be also addressed.

2 Labor Bonding

Labor bonding institutions of Europe, as well as of East Asia and the U.S. are examples of successful bonding. If one were to model the effect of bonding institutions on output, the utility function of agents should take into account consumption, as well as improvements in working conditions and labor productivity. Farmer and Woodford (1997) and Farmer (1999) describe such an utility function in a model where a dynamic system yields two outcomes. The one with a higher output level is desirable but unstable and unattainable, and it is called full employment in the theoretical exercise of this chapter. The other one is stable but has undesirably low production levels. One could add in this model bonding institutions that reduce agents' disutility from work through better working conditions or free school and health care to their children and look at the dynamics they generate in output in the long run. Small perturbations, such as increased public expenditures for mere government consumption, are considered in order to check if such a policy of pursuing full employment through bonds that affect the labor market is viable.

2.1 No Government Consumption

With no government consumption (interpreted as an efficient government able to reduce its consumption of public resources for administratative purposes to an optimal level) the dynamics of output (y_t) with bonding expenditures is described by the following graph:

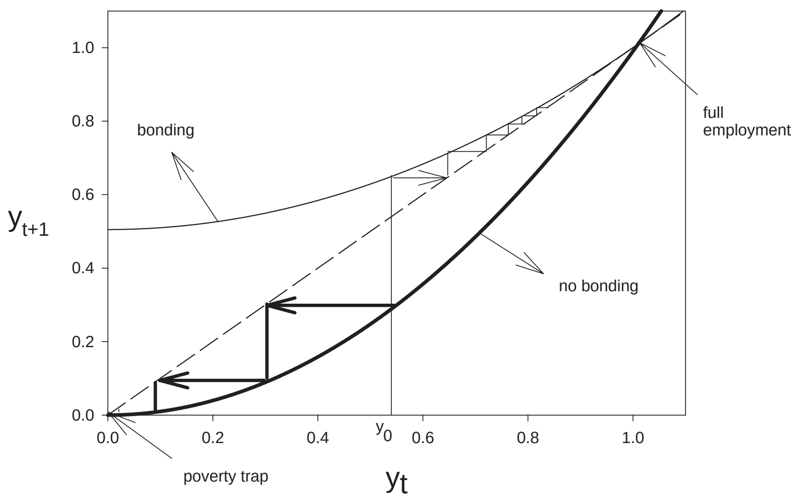

Figure 1: Bonding - Stabilizing Full Employment Output

In this case, without bonding institutions, the equilibrium with a lower level of output is an attractor (a poverty trap as defined by Azariadis) and its evolution path over time is shown by the full line in the above graph. An undesirable output is reached by this economy because there are no institutions to favor exchanges between current and future generations. An economic policy of full employment would bond present and future generations through a social safety net that allows working agents to increase their productivity and maintain in this way the purchasing power of those that are old or socially weak, to bond working agents to the government through economic measures that improve the working conditions, generate increases in output, therefore wages, consumption, and an expansion of indigenous demand and market. This change in the internal dynamics of the system is shown by the thin line in the graph. An economy starting at the initial level of output y_0 it is able to increase production and reach full employment in the long run.

3 Government Consumption

We have been so far in an ideal environment where collected public expenditures are completely returned to the economic agent through various bonds that generate lower disutility from work. Other costs such as the cost of communication between group members, the costs of educating, equipping and protecting a formal group organization in charge of the new policy should not be neglected (Olson, 1965). These administrative costs do not affect the disutility from work of agents, yet without them the institution cannot properly run. It is obvious that with positive levels of government consumption - interpreted as being above their efficient level - public resources that need to be allocated to bonding diminish, or are not properly used due to an inefficient bureaucracy. After developing an efficient administration, success was on the side of those economies that had managed to use public resources for growth enhancing policies. However, some have failed to sustain growth despite important resources allocated to bonding. What are the possible explanations for such failures of bonding institutions?

4 Labor Bonding Failures

The most notable failure of labor bonding occurred in eastern Europe in the 90s, when reductions in output on a big scale induced profound economic changes that included overnight dismantling of bonding institutions, going as far as country dismemberment - as it was the case of the Soviet Union and Yugoslavia.

The dissolution of the Soviet Union and Yugoslavia has fuelled an intense process of nation state creation (similar in intensity to the one after the collapse of the Ottoman and Austro-Hungarian empires at the end of the first World War). Newly formed states embarked in the long process of bringing to existence a state bureaucracy to perform tax collection and a well-functioning monetary system. This process is not easy, as demonstrated by the failure of many of the governments in the newly created nation states to organize a coherent administration able to collect taxes and create incentives to prevent corruption of public officials. In this period of bonding dissolution even countries with older administrative systems in the region have faced a rampant inability to undertake classical functions of the state, such as tax collection and resource management. That triggered an acute lack of funds for further bonding policies.

Easterly (2001) argues that the failure of bonding institutions in these countries was generated by public overspending. For example, even though there were sustained efforts in educating the labor force, high-skilled people have emigrated to the developed countries because there was no high-tech machinery to complement their skills in their native economies. In this way, states the author, skills go to waste, and so do public resources. That is a debatable statement, if one takes into account that labor skill exports have always been an important source of revenue for developing as well as developed countries. Skill emigration does not necessarily occur only for lack of matching machinery; it could be because of lower incomes and wages in one country, or social unrest, or simply the possibility of more fulfilling career paths in other countries. Investment in bonding pays off in the long run only, meaning that over- or underinvestment is easy to occur. It is probably not only overspending that has failed bonding, it is also the premature bonding that has generated it. Ex-Yugoslavia is a a case of a country able to promote policies to increase income and productivity and which had to face war and wealth destruction because a bureaucracy that serves a national state had been inexistent. Latin American countries are another case of premature bonding where each country had hundreds of health insurance and pension systems to defend the interests of a minority rather than to bond various groups of workers.

Moreover, even successful bonding would have to be dismantled or reformed once its goal of higher outputs and larger markets has been reached. Western Europe comes as a clear example. It has to reform its interstate institutions to be able invest in expanding markets toward East Europe; it also has to find new forms for its intrastate bonding institutions. Japan is a more complex case. On one hand the crisis that has been affecting Japan for the last ten years was due to mis-bonding, especially by promoting highly efficient firms and products on the external markets and using the surplus of revenues to cover inefficient industries at home (Katz, 1998). On the other hand cases of overspending in bonding are made more visible by increases in national wealth.

5 Conclusion

Effective or not, labor bonding institutions have clearly influenced the evolution path of productivity and output in many countries in the second part of the XXth century. The fact that they pay off in the long run makes them hard to implement. Overspending, improper pacing in introducing bonding have caused their failure in many countries. However, one could should not fall into the other extreme of denying better working conditions, improvements in health care and education, even when these public resources spent in a developing country are used in the end by a developed one, due to labor flexibility. Rather than seeing such movements as a waste for the developing country, one should also see it as a process of international bonding to the markets of a more developed country whose results will probably be seen in the long run.

Failures and successes of bonding teach us that bonding institutions have to occur in steps, once a mature and motivated bureaucracy is in place, able to collect and administer resources needed by these new long run of policies, once the output in an economy has reached a level able to support these increases in public expenditures, once the mentalities of the society have reached a stage in which groups with different interests are willing to accept the rules imposed by a new institution demanding higher costs and offering in exchange bonds that will pay off only in the long run. Successful bonding requires also a reform so that public payments are reduced or even ceased.

References

[1] Azariadis, C. 1996. 'The Economics of Poverty Traps. Part One: Complete Markets'. *Journal of Economic Growth.*

[2] Easterly, W. 2001. *The Elusive Quest for Growth.* MIT Press. Cambridge.

[3] Eichengreen, B. 1996. 'Institutions and Economic Growth: Europe after World War II' in Crafts, M. and Toniolo, G. (eds). *Economic Growth*

in Europe since 1945. Center for Economic Policy Research, Cambridge University Press.

[4] Castley, R. 1997. *Korea's Economic Miracle. The Crucial Role of Japan.* MacMillian Press Ltd.

[5] Katz, Richard. 1998. *Japan, the System that Soured.* M. E. Sharpe. New York.

[6] Olson, M. 1965. *The Logic of Collective Action: Public Goods and the Theory of Groups* Harvard University Press.

[7] Sen, A. 1999. *Development as Freedom.* Alfred A. Knopf. New York.

[8] von Mises, L. 1993. *Liberalismus.* Academia Verlag. Berlin.